BEFORE THE ARIZONA CORPORATION COMMI 1 2 2002 FEB 25 P 2: 55 WILLIAM A. MUNDELL 3 4 **CHAIRMAN** AZ CORP COMMISSION 5 JIM IRVIN DOCUMENT CONTROL COMMISSIONER 6 MARC SPITZER 7 COMMISSIONER 8 9 IN THE MATTER OF THE GENERIC DOCKET NO. E-00000A-02-0051 10 PROCEEDINGS CONCERNING ELECTRIC) 11 RESTRUCTURING ISSUES 12 13 IN THE MATTER OF ARIZONA PUBLIC DOCKET NO. E-01345A-01-0822 14 SERVICE COMPANY'S REQUEST FOR 15 VARIANCE OF CERTAIN REQUIREMENTS) 16 OF A.A.C. R14-2-1606 17 18 IN THE MATTER OF THE GENERIC DOCKET NO. E-00000A-01-0630 19 20 PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING 21 **ADMINISTRATOR** 22 23 DOCKET NO. E-01933A-02-0069 IN THE MATTER OF TUCSON ELECTRIC 24 POWER COMPANY'S APPLICATION FOR 25 26 A VARIANCE OF CERTAIN ELECTRIC 27 COMPETITION RULES COMPLIANCE 28 **DATES** 29 DOCKET NO. E-01933A-98-0471 IN THE MATTER OF THE APPLICATION 30 OF TUCSON ELECTRIC POWER COMPANY) 31 FOR APPROVAL OF ITS STRANDED COST) 32 33 RECOVERY 34 RESPONSE OF ARIZONANS FOR 35 **ELECTRIC CHOICE AND** 36 **COMPETITION TO** 37 **COMMISSIONERS' QUESTIONS** 38 39 40 Arizonans for Electric Choice and Competition hereby submits its responses to the 41 questions of the Commissioners in the above-captioned proceeding Arizona Corporation Commission 42 DOCKETED

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FIRST SET OF QUESTIONS FROM CHAIRMAN MUNDELL

1	FIRST SET OF QUESTIONS FROM CHAIRMAN MUNDELL
2 3	
4	I. Identification of Retail Electric Products and Services for Which
5	Competition Could Bring Benefits
7 8	A. What are the possible goods and services traditionally provided by the
9	electric utility for which retail competition is possible?
10	In the strictest sense, retail competition is possible for most, if not all, of the goods
11	and services traditionally provided by vertically-integrated electric utilities. However, not
12	all of the goods and services traditionally provided by the electric utility should necessaril
13	be delivered through retail competition. Retail electric competition is best applied when it
14	opens the market to competitive delivery for those goods and services for which a
15	reasonable expectation of consumer benefit exists: namely, the supply of electric
16	generation and associated revenue cycle services (e.g., metering, metered data acquisition,
17	meter data management, billing and payment).
18	You may address the following categories of goods and services:
19	1. generation, including baseload, intermediate and peaking
20	power; green power; distributed generation; firm and nonfirm
21	power; long- and short-term contracts; backup and coordinatio
22	services:
23	The following table addresses the questions about specific competitive services.
24	For the balance of these questions, AECC's responses regarding "retail competitive

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services" are directed toward generation and revenue cycle services.

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TYPE OF GENERATION	POSSIBLE TO PROVIDE	RECOMMENDED AS
SERVICE	IN RETAIL	PART OF RETAIL
	COMPETITION?	COMPETITION?
Generation baseload	Yes	Yes
Generation intermediate	Yes	Yes
Generation peaking power	Yes	Yes
Generation green power	Yes	Yes
Distributed generation	Yes	Yes
Firm generation	Yes	Yes
Non-firm generation	Yes	Yes
Short-term contracts	Yes	Yes
Long-term contracts	Yes	Yes
Backup services	Yes	Yes
Coordination services	?	?

2. distribution services, including ownership, construction, maintenance and repair of the physical lines; metering ownership, installation, reading and data analysis; and the process of planning for and negotiating with distributed generators:

In AECC's view, competition in distribution services is generally unlikely to benefit consumers and may result in negative impacts such as duplication of existing utility infrastructure. AECC believes that negative affects such as these would unnecessarily complicate distribution system management and not produce net benefits to consumers. However, retail customers should be able to bypass the distribution system entirely by taking service directly from the transmission system, while still remaining state jurisdictional customers.

TYPE OF DISTRIBUTION	POSSIBLE TO PROVIDE	RECOMMENDED AS
SERVICE	IN RETAIL	PART OF RETAIL
	COMPETITION?	COMPETITION?
Distribution services	Yes	No
Distribution ownership	Yes	No
Distribution construction	Yes	No
Distribution maintenance	Yes	No
Distribution repair	Yes	No
Meter ownership	Yes	Yes
Meter installation	Yes	Yes
Meter reading	Yes	Yes
Meter data analysis	Yes	Yes
Distributed generation	Yes	No, as it relates to UDC
negotiations and planning		facility impacts

3. aggregation services, such as load profiling; planning; customer services; data analysis; billing; generation planning; power supply acquisition; demand side management, energy efficiency and other services relating to matching supply and demand.

"Load profiling" generally refers to the creation of standardized load shapes for use in imputing hourly demand levels for customers without interval meters. This exercise is necessary to enable customers without demand meters to be able to shop competitively. By its nature, load profiling involves the creation of a standardized product to be used by all retail providers. Consequently, load profiling does not lend itself to being provided competitively.

"Planning" is a broad term that covers many activities. Generally, planning to provide competitive services is a competitive activity, whereas planning to provide non-competitive services (e.g., transmission, distribution) is not.

TYPE OF "AGGREGATION" SERVICE	POSSIBLE TO PROVIDE IN RETAIL COMPETITION?	RECOMMENDED AS PART OF RETAIL COMPETITION?		
Load profiling	No	No		
Planning	Broad term: Encompasses non-competitive and competitive activities	Broad term: Encompasses non-competitive and competitive activities		
Customer services	Yes	Yes		
Billing	Yes	Yes		
Generation planning	Yes	Yes		
Power supply acquisition	Yes	Yes		
Demand Side Management	Yes	Yes		
Energy efficiency	Yes	Yes		

B. For each good or service for which competition is possible, what are the possible benefits of competition for each good and service?

1. What are the potential price benefits?

As a general proposition, competitive markets cause goods to be sold at their long-run marginal cost, and ensure that the long-run marginal costs are the lowest that are technologically feasible. This is the potential price benefit of competition in generation services, and is the basic economic premise underpinning the entire U.S. economy.

This is not to say that products will be priced at long-run marginal cost at all times. During periods of excess capacity, prices can be expected to fall below long-run marginal costs (although not below short-run marginal costs); conversely, during periods of supply scarcity, prices can rise well above long-run marginal costs. Within the past five years, western wholesale markets have experienced both of these phenomena.

Experience has shown that a large part of the potential price benefit of retail competition will be driven by contract structures developed by providers in negotiations with consumers. Consumer input to the contracting process has resulted in innovative delivery of pricing and risk management structures in other deregulated electricity markets.

Retail electric contracts in current use run the gamut from fixed, multi-year structures to monthly index-based designs, with and without risk management products such as caps, floors, and collars.

2. Do the potential price benefits differ in the short-term and longterm?

They may differ. Short-term price benefits to customers may occur from an excess supply situation in which price is temporarily driven below the long-run cost of production. Long-term benefits are related to the establishment of long-run costs of production that are lower than they would otherwise be without competition.

3. What are the potential non-price benefits?

Open markets breed product offerings with both price and non-price characteristics. Potential non-price benefits of retail electric competition include innovations in customer service, accelerated product development cycles, improved provision of information to customers, more flexible product packaging opportunities (e.g., cogeneration combined with Direct Access service), improvements in contract terms, increased availability of risk management tools, greater consumer input in product development and service delivery, and product innovation.

4. Are there any other potential benefits (e.g., environmental, energy security, etc.)?

To a certain extent. For example, retail access can provide a market niche for "green power." In addition, more inefficient power plants are generally more costly to operate than modern, energy-efficient plants, and, as generation supply increases due to competition, inefficient plants are likely to be "out of the money" on an increasingly-

frequent basis. Note that this general tendency is sometimes offset by specific circumstances, such as "must-run" conditions, in which a plant's location on the grid makes it necessary for it to operate for reliability reasons, even at costs that are above market.

II. Determination of the Feasibility of Competition

- A. Are the product and geographic markets for the good or service conducive to effective competition or manipulation by a single entity?

 For example-
 - 1. Are there economies of scale which make it most efficient for the service to be provided by a single company?

Generally, in any geographic area, there are economies of scale in providing wires services (i.e., distribution and transmission) that make it most efficient for the service to be provided by a single company. For competitive retail services, economies of scale are important – particularly for the establishment of "critical mass" – but these services are not "natural monopolies."

2. Are there economies of scope which make it most efficient for the service to be provided in a bundle with certain other services?

There may be some economies of scope that extend from one service to others. At the same time, natural "economies of scope" must be distinguished from vertical market power. The former is a matter of efficiency advantage, whereas the latter is a market structure advantage that allows one participant to preclude other parties from making their

own efficiency gains.	In the case of competitive retail services, AECC believes that
economies of scope ar	e outweighed by the opportunity for competitive benefits.

- B. Are or will there be a sufficient number of competitors in each potentially competitive market?
 - 1. Is the product or service one which viable competitors will actually be interested in providing?

Yes. The AECC recently surveyed the energy service provider community to determine the level of interest in supplying competitive energy services within Arizona. Within the last six months, while market fundamentals have been improving and wholesale prices for electricity have dropped toward historical averages, several ESPs have indicated their expectation to pursue opportunities in Arizona as early as 2002. When wholesale market conditions permit, we expect ESPs will reestablish their commodity marketing efforts in Arizona, which will be accompanied by renewed interest in offering revenue cycle services. Several DSM service providers are currently working with Arizona customers and have been continuously active in marketing and installing demand reduction, energy information, and energy efficiency projects.

2. Is the cost of aggregating customers sufficiently small, relative to likely revenues, which new suppliers will find it profitable to enter?

One of the biggest challenges for new ESPs is creating sufficient critical mass to be competitive with incumbent utilities. This critical mass is important not only for spreading fixed costs, but also in providing load diversity. In this sense, all ESPs are "aggregators." Challenges notwithstanding, aggregation of consumers for retail electric services has

occurred in the U.S. Where it has occurred, a variety of market approaches have been
adopted, many of which could occur here in Arizona under the appropriate market
conditions. In some states undergoing the transition to competition, ESPs have taken step
to structure their mid-market sales, vis-a-vis aggregation, by using agents to reduce costs
and improve margins. Other aggregations are the output of industry organizations (eg;
manufacturers associations, hospital associations, etc) whose membership share common
goals and procurement interests. Still other aggregations occur due to the natural interest
of physically separate business units of the same company or holding company to exploit
the advantages of an aggregated transaction.
3. Are there technical, legal, or other barriers to entry in the
markets? For example:

Are there legal or technical barriers to the construction of the different types of generation plants by non-utilities?

While there are significant hurdles that must be overcome to bring a power plant on-line, these hurdles are not unique to plants constructed by non-utilities. Non-utility generation has demonstrated that it is a major source of new power supply across the United States and in Arizona.

b. Is the cost of obtaining licenses, resources, knowledge and employees sufficiently small, relative to the expected revenues, such that new entrants will find the market attractive?

In the case of competitive generation, the answer is already well-established in the affirmative. In the case of ESPs, the answer will depend on the opportunities vis-à-vis

standard offer service. Nationwide (and in Arizona) ESPs have shown a willingness to invest to establish critical mass when there was a perceived opportunity to compete with the incumbent utility.

C. Is it necessary for the product or service to be provided by a single regulated company to assure reliability and safety, or can multiple companies that provide the service subject to reliability and safety rules?

Reliability and safety are provided through Control Area Operations (at the transmission and ancillary services level) and by the UDC at the distribution level. Neither Control Area Operations nor UDC services are competitive. Today, Control Area Operations are performed by transmission providers such as APS, SRP, and TEP. In the future, this function will be under the authority of an RTO (such as WestConnect). Through the Desert STAR process (as adopted by WestConnect) a great deal of effort has gone into developing Control Area protocols that would ensure reliability and safety in a regime of competitive wholesale and retail generation markets.

D. For customers, is the cost associated with learning how to shop and actually shopping sufficiently small, relative to the expected benefit, that customers will want to shop?

Yes, although obviously, there will be differences from customer to customer. Generally, when market conditions support shopping, more sophisticated customers are likely to move to Direct Access service first. "More sophisticated" does not necessarily mean "larger," as retail stores with high load factors are often sophisticated energy users that will take advantage of shopping opportunities. AECC's understanding is that in the

first year of Direct Access in Arizona – prior to the run-up in wholesale prices – over 300 accounts in the APS territory took Direct Access service, an indication that the general answer to this question is: "yes."

III. Relationship of the Current Regulatory Regime to Competition

A. For each potentially competitive product or service, how does current state and federal regulation foster or inhibit (a) retail competition and (b) wholesale competition?

Federal regulation is generally neutral with respect to retail competition for generation services, unless a state adopts a retail access program; if the latter occurs, Federal regulation becomes generally supportive of retail competition, with FERC taking the general position that access to transmission service for retail transactions shall be non-discriminatory. AECC's experience, however, is that FERC regulations and pro-forma transmission tariffs generally do not anticipate the special considerations and detail necessary to implement retail access fairly; for this reason the Arizona ISA and its protocols were formulated. AECC views FERC's approval of the Arizona ISA and its protocols as evidence of FERC's support for the implementation of Arizona's retail access program.

Arizona state regulation has been highly favorable for retail competition. The primary barrier to customer participation has been high wholesale prices that have not been able to compete favorably with standard offer rates. As this circumstance changes, and if Arizona state regulation does not begin to impede retail access, AECC expects that retail customers will again seek opportunities in the competitive generation market.

With respect to wholesale competition, Federal policy is generally supportive, although last year's experience in California has stirred a great deal of criticism of the quality of Federal regulation of wholesale markets. From a purely jurisdictional standpoint, the state role in wholesale markets is much more limited, but is extremely influential with respect to siting approval for new generation.

16.

B. How can the commission protect Arizona customers from the risks of competition while promoting competition?

The current transition plan has achieved this objective so far by offering customers a choice: standard offer service at regulated prices or Direct Access service at market prices. This transition plan will be in place in the APS territory through July 1, 2004 and in the TEP territory through December 31, 2008. One of the elements differentiating Arizona's transition plan from that of California is that Arizona's standard offer service pricing requires "bottom line" results without micro-managing how the utilities achieve these results. For example, unlike California, Arizona utilities have been free to purchase power on the forward market and to manage their own generation resources to meet standard offer pricing requirements in the Settlement Agreements.

With regard to post-2004 standard offer service in the APS territory, the Commission faces an alternative presented by APS. The Commission can stick with the original game plan that calls for the standard offer provider to procure the resources for standard offer service in the competitive wholesale market, or the Commission can consider APS' request to procure most of this resource from a long-term contract with its affiliate. In either case, the Commission's current policy of allowing the choice of Direct Access service for all customers should not be impacted or changed.

The alternatives for procuring standard offer service present a tradeoff. The very substantial activity in building new generation resources in Arizona since the adoption of the Competition Rules provides an endorsement of the original game plan. This type of interest in providing generation – financed entirely at investors' risk – is exactly the outcome that was hoped-for when Arizona decided to allow market forces to determine how much new generation would be constructed.

Countering that positive outlook are two issues raised by APS: (1) Will the 2000-01 experience with extraordinary wholesale prices in the West be repeated after 2004?; and (2) Are the mechanics of purchasing 50 percent of the generation needed for standard offer service feasible in light of merchant plant locations and existing transmission constraints? APS' alternative – a long-term contract with an affiliate at cost-based rates – would insulate standard offer customers, to a certain extent, from extraordinary price spikes. At the same time, standard offer customers would not receive the benefit of lower generation prices when supply is plentiful. Thus, the APS proposal addresses the issue of standard offer price risk – but at a cost.

AECC notes that regardless of the standard offer resource option selected, the Commission will retain the final say over standard offer rates.

With respect to the APS Variance Proposal, AECC believes it is important that competitive bidding proceed as required in the Competition Rule for substantially more of the electric supply for standard offer service than the APS Variance request is willing to consider. APS has raised concerns about whether a 50 percent requirement would create undue upward price pressure on standard offer service. AECC does not object to the Commission reviewing the amount of electric supply for standard offer service that should

be competitively bid. AECC believes that, after such review, this	amount s	should	be so	et at
the maximum level that is in the public interest.				

C. How have the interim rate reductions for customers receiving standard service affected the ability or desire of generation suppliers to compete in Arizona retail markets?

Strictly speaking, the APS and TEP rate reductions implemented since the approval of the Settlement Agreements are not "interim" in nature, as that term is usually used in regulatory parlance.

All things being equal, rate reductions for standard offer service make it more difficult for a competitive ESP to compete with the standard offer. Nevertheless, AECC supports (and bargained for) the standard offer rate reductions in the Settlement Agreements. AECC opposes a philosophy that would keep standard offer rates artificially high in order to induce retail competition. Moreover, given the astronomical heights reached by wholesale prices in 2000 and early 2001, the rate reduction for standard offer service had no material impact on whether a customer opted to remain on the standard offer.

D. Do Commission policies or legal requirements ensuring that utilities recover investments from ratepayers affect the prospects for competition in any market for which competition otherwise would be possible?

All things being equal, stranded cost charges create a barrier to direct access service. However, AECC considers this issue to have been resolved within the framework

1	of the Settlement Agreements, which provide for payment, and ultimate termination, of
2	stranded cost charges.
3	E. Does continuing utility control of depreciated generation assets affect
4	the ability of competing suppliers to enter retail markets?
5	During periods of relatively high market prices, control of depreciated generation
6	assets may make it possible for a utility to sell below market prices without incurring
7	losses. However, AECC notes that one of the major questions addressed in the retail access
8	debate in Arizona (and elsewhere) concerned stranded cost - a concept which presumes
9	that utility assets would generally be burdened by high fixed costs and therefore unable to
10	compete at (low) market prices.
11	F. How does current Commission regulation promote or deter the ability
12	of (1) renewables, (2) distributed generation, and (3) energy efficiency
13	and demand side management to compete with traditional generation
14	resources?
15	AECC has not had sufficient time to fully research the role of the Commission's
16	current regulation with respect to all these items. However, with regard to distributed
17	generation, the Commission should ensure that standby service rates and interconnection
18	requirements are reasonable. In particular, the former tend to be an obstacle to the
19	development of distributed generation in Arizona.
20 ,	G. What are the risks of moving to a regime of retail competition for each
21	product or service and what are the methods for managing those risks?
22	Please see response to III.B, above.

of the Settlement Agreements, which provide for payment, and ultimate termination, of

1	H. If the current regime is not conducive to retail competition for a
2	particular product or service, what actions should the Commission take
3	to promote its success in the future?
4	In AECC's view, the current "regime" is not an obstacle to retail competition for
5	generation service - the obstacle has been high wholesale prices.
6	Specifically –
7	1. Should the Commission require utilities to procure particular
8	products or services from unaffiliated competitors?
9	AECC does not have any specific recommendations on this question at this time. We
10	note, however, the importance of "functional separation" with respect to wires services, i.e., the
11	provider of standard offer services should not receive any preferential treatment in receiving
12	transmission and distribution service vis-à-vis providers of generation service to Direct Access
13	service.
14	2. Are utilities taking steps that will make competition more
15	difficult down the road (e.g., retail marketing, internal
16	restructuring, entering into agreement to avoid customer self
17	generation)? If so, identify those steps and how the Commission
18	should respond.
19	Aside from occasionally adopting postures that undercut the Arizona ISA,
20	AECC is not aware of any steps being taken by utilities under the Commission's
21	jurisdiction that would make competition more difficult down the road.

1	3. Are utilities entering into long-term contracts with existing
2	customers? If so, how do they affect prospects for future retail
3	competition? Should the Commission allow them?
4	AECC is not aware of new long-term contracts between customers and utilities
5	under the Commission's jurisdiction. (SRP is offering 3 and 4-year contracts to larger
6	customers.) The existing Competition Rules allow long-term contracts under certain
7	conditions, which AECC supports.
8	4. Should the Commission consider instituting competition for
9	billing and metering services even if retail generation
10	competition is premature?
11	It is AECC's understanding that billing and metering are already competitive in
12	accordance with the Electric Competition Rules.
13	
14	IV. Retail Generation Competition
15	A. Regarding each identifiable generation product -
16	1. Identify with particularity any defects in the wholesale market
17	structure affecting Arizona.
18	Arizona utilities have been buying and selling power in the western wholesale
19	market for a considerable period of time, and it appears that, with the significant exception
20	of 2000-01, this market works well. In fact, the largest wholesale trading hub in the
21	western United States is at Palo Verde. However, there is no question that during 2000-01
22	western wholesale markets experienced astronomical prices. Parties may differ as to

whether the market was "defective" or simply reflective of a severe capacity scarcity

following years of growing demand without sufficient additions to supply. After considerable public pressure and controversy, FERC determined that western markets were in fact "dysfunctional" during that period. A key finding was that at very high levels of demand, generators accrued considerable market power that was exercised to send wholesale prices sky-high. In addition to imposing wholesale price caps through September 2002, FERC also forbade generators from withholding supply from the market.

Since Spring of 2001, wholesale prices have stabilized considerably as new generation has come on line, demand has softened, gas prices have come down, and purchasers have better utilized forward (instead of spot) markets to secure resources.

Arizona in particular is witnessing unprecedented growth of generating capacity, although some of this activity may slow down in response to lower wholesale power prices.

2. Are there an adequate number of competitors to sell in Arizona to make the product sufficiently competitive? How many sellers are there?

Sellers here include both generation suppliers and ESPs. With Palo Verde being the largest trading hub in the western United States, a large number of players can reach the Arizona market. As new generation is added to the region by independent generators, the prospects for competition improve further. As the western market stabilizes, the next couple of years will be very revealing regarding its efficacy. AECC anticipates that the marketplace will increase in robustness, but recognizes that nothing is guaranteed.

With respect to ESPs, a significant number went through the Arizona application process, demonstrating a potential for viable retail competition. During the period of high wholesale prices, most ESPs naturally became inactive. With a return to more attractive

wholesale prices, and with the prospect of s	stranded	cost charges	disappearing	from most of
the state by the end of 2004, AECC expects	s that ES	P interest in	Arizona will	improve.

3. How have mergers and consolidations in the industry affected the competitiveness of the product in the region at the wholesale and retail levels?

Utility merger activity continues to proceed in the U.S., although at somewhat reduced levels from the M&A heyday of the late 1990's. Nationwide, the effect of utility mergers is that ownership of IOU power generation capacity is becoming more concentrated. DOE research indicates that in 1992, 70 electric holding companies owned 78 percent of the IOU generating capacity. By 2000, only 53 holding companies were expected to own nearly 86 percent of the IOU generating capacity – due, in large part, to M&A activity. It is interesting to note that a report in *The Electricity Journal* in 1999 indicated that only 15 percent of the mergers to date had achieved their expected financial results.

This national merger activity notwithstanding, the key issue here is whether there are enough independent players in a the regional market to ensure robust competition.

AECC's observation is that with the influx of independent generators, the number of players on the regional scene appears to be increasing.

Finally, we note that besides the traditionally generation-related merger activity by IOUs and IPPs, a new trend has become evident. Due to the lower capital and O&M costs of natural gas fired generation, 90 percent of future capacity is projected to come from natural-gas-fired combined-cycle or combustion turbine technology. As a result, utilities, IPPs, and marketers are enacting strategies to acquire upstream and mid-stream natural gas

transportation and storage resources both to supply proprietary generating resources and to expand into gas sales markets. Mergers of electric and gas utilities, so-called "convergence" mergers, are a reaction to the swing in reliance on natural gas as a fuel source for generation built to meet current and future demand.

4. Are competitors building new generation able to price their generation at rates competitive with existing generation?

In a competitive market they will have no choice but to sell at the market-clearing price.

5. How has the Independent System Administrator affected the success of (a) retail competition and (b) wholesale competition?

Retail competition has been dormant in Arizona due to the high wholesale prices experienced in 2000-01. With wholesale prices now stabilizing, we expect interest in Direct Access to resume. When that occurs, the Arizona ISA will be necessary to ensure the success of retail competition prior to the operations of an RTO.

Until an RTO is operational, there are simply no rules or protocols in place that address the unique transmission access needs associated with implementing a state retail access program. Some parties may contend that mere reliance on existing FERC-approved open-access transmission tariffs is sufficient. Such a view is simply wrong. Standard FERC-approved transmission tariffs were developed with wholesale transactions in mind: they are woefully inadequate for dealing with the special challenges of retail competitive service, as will be shown below. Obviously, FERC concurs with our view, at least implicitly, as FERC has approved the Arizona ISA Protocols and Tariff, which were

developed to be used instead of the utilities' wholesale transmission tariffs for retail transactions in Arizona.

Competitive retail service provides many special challenges that come under the general rubric of "transmission access," including, among other things, the need to adapt transmission scheduling requirements to be compatible with retail competitive service, the tailoring of ancillary services to support retail transactions, the determination of equitable energy balancing requirements, and the establishment of efficient and equitable rules to ensure the provision of "must-run" generation in load pockets such as Phoenix and Tucson. The Arizona ISA Protocols address each of these special challenges — and provides a mechanism for resolving disputes associated with them.

But no special challenge in the establishment of competitive retail service is important as the fundamental question of transmission allocation among retail customers. When the Commission's Electric Competition Rules were being developed, transmission allocation was a topic of considerable controversy. In a transmission system that is heavily used, certain paths become "congested" – that is, parties wish to schedule more transactions over certain paths connected to important generating facilities and market hubs than the transmission facilities can reliably accommodate.

Initially, Arizona utilities contended that customers who purchased from competitive suppliers would have access only to those transmission paths that were not needed by the utility to serve its own standard offer customers. In other words, the most valuable transmission paths would be unavailable to competitive customers. AECC and other parties pointed out that such an approach would doom retail competition to failure.

Moreover, today's standard offer customer could be tomorrow's competitive customer —

and that customer should not be forced to forfeit its ability to be served using the most important transmission paths simply because it switched power providers.

Ultimately, the Commission required that competitive customers receive a pro-rata allocation of transmission rights on the paths used to provide retail service. The details implementing this requirement were painstakingly negotiated under the auspices of the Arizona ISA and incorporated into the Protocols Manual. Later, to resolve a "critical mass" problem for the initial competitive suppliers, the Arizona ISA adopted an interim transmission allocation (with the cooperation of the utilities and the approval of FERC) that assured access to important market hubs for certain threshold amounts of competitive retail service.

In short, retail competition cannot occur without a means for fairly and efficiently allocating transmission. In Arizona, this function is performed by the Arizona ISA. This function will transfer to an RTO (using a different allocation mechanism, but similar principles) when an RTO becomes operational. Under the most optimistic projections, an RTO will not be operational in Arizona until 2004.

By design, the Arizona ISA has no role in wholesale markets.

- B. Regarding the transmission and distribution infrastructure necessary to support competition for each identifiable generation product --
 - 1. Are there transmission constraints inside or outside Arizona that currently impede the ability of competitors to reach Arizona customers during any reasons of the year or times of the day?

Yes. While transmission providers can provide better detail for this question,
AECC is aware of transmission constraints into Phoenix for peak hours of the day in the

summer,	into Tucson for pea	ak hours of the	day for mu	ch of the ye	ear, into	Yuma,	and out	of
Four Cor	ners into Arizona.		i i					

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2. What plans are in place to relieve transmission constraints?

AECC expects that transmission providers will provide the necessary detail for this question. We are aware that three additional 500kV lines and one 345kV line connecting several load centers, generation switchyards, and substations are being constructed in Arizona, and that as of February 7, 2002, APS and SRP received the Commission's approval of the Southwest Valley 500kV line. We note that while it is generally desirable to see transmission constraints relieved, transmission construction is not always the most efficient means for accomplishing this. In particular, it is sometimes more efficient to construct new generation on the congested side of the transmission interface.

3. How long will it take to relieve any existing transmission constraints and what factors are affecting and will affect prospects for relief?

AECC expects that transmission providers will provide the necessary detail for this question. We note that factors affecting the prospects for relief include: 1) individual transmission owners' site selection processes, including public comment, 2) the state's site approval process, and 3) the efficacy of the planning process ultimately adopted by an RTO.

4. Are the owners of constrained transmission facilities, or holders of transmission rights, able to use their control to affect market prices?

Yes. In retail markets this can occur when ESPs providing Direct Access service are
treated as "last in" or incremental to the existing transmission reserved for serving native
load. At one time this issue was hotly debated in Arizona, but was finally resolved in favor
of the AISA protocols that ensure fair treatment for ESPs. In AECC's opinion, the
congestion management protocols filed at FERC by WestConnect (as developed in the
Desert STAR process) will also treat ESPs (and other transmission customers) fairly with
respect to congestion management.
5. Are these transmission owners currently doing things that will

5. Are these transmission owners currently doing things that will allow them to exert more or less control in the future? If so, please detail.

Transmission owners have agreed to the formation of the Arizona ISA, which provides a means for ensuring fair delivery of Direct Access service prior to the formation of an RTO. When an RTO becomes operational (2004-05?), functional separation between transmission and utilities' merchant operations will increase, and congestion management will be performed by the RTO. This change will result in individual companies having less control over congestion management functions.

6. Will the transmission system be adequate prospectively (e.g., in the next, 5, 10, 15, 20 years) to deliver power from new generation plants?

AECC expects that transmission providers will provide the necessary detail for this question.

7. Is the natural gas pipeline infrastructure adequate to support all proposed new gas-fired generation plants? How many plants can it support?

Based on discussions with both El Paso Natural Gas and Southwest Gas, AECC has learned that the currently existing natural gas infrastructure would not adequately supply all the gas-fired generation plants proposed for Arizona. However, the Line 2000 conversion by EPNG, other intra- and interstate pipeline projects, and gas storage project development in Arizona indicate that transporters are responding to the demand for natural gas. In all likelihood, some portion of the planned generation will not be built as scheduled, or perhaps will never be built. We also believe that generation developers are unlikely to take the risk of building out gas-fired generating projects without long-term gas supplies.

8. Does the transmission and distribution system facilitate or deter

a. The development of renewable energy technologies?

As a general proposition, the transmission and distribution system neither facilitates nor deters the development of renewable energy technologies. We note, however, that many applications of renewable electricity technologies such as biomass, geothermal, hydro, and wind power are confined to geographic and geologic areas where their feedstock exists. The likelihood that these renewable feedstocks will be in close proximity to the transmission system is a matter of chance.

b. The development of distributed generation?

As a general proposition, the transmission and distribution system neither facilitates nor deters the development of distributed generation. Perhaps the greatest institutional barrier to distributed generation is the structure and pricing of utility standby service tariffs

and demand ratchets. We note also that the operator of a distributed generation facility must sign an interconnection agreement with the local utility. For interconnection into the transmission system, a FERC-approved pro-forma interconnection agreement is used. For interconnection into the distribution system, a "non-FERC" interconnection agreement is used in Arizona. While the distribution system interconnection agreement has the advantage of being tailored to smaller-scale projects, many of the terms of this agreement are less favorable to the distributed generator than the FERC-approved pro-forma agreement.

c. The development of demand-side management and energy efficiency?

As a general proposition, the transmission and distribution system neither facilitates nor deters the development of DSM and energy efficiency.

C. Regarding competitive bidding -

1. Identify with particularity any adverse consequences that would result from Commission approval of a substantial variance to the electric competition rules that require competitive bidding for 50% of the electric supply for standard offer customers, starting in 2003.

AECC believes it is important that competitive bidding proceed as required in the Competition Rule for substantially more of the electric supply for standard offer service than the APS Variance request is willing to consider. APS has raised concerns about whether a 50 percent requirement would create undue upward price pressure on standard offer service. AECC does not object to the Commission reviewing the amount of electric

supply for standard offer service that should be competitively bid. AECC believes that, after such review, this amount should be set at the maximum level that is in the public interest.

Specifically:

a. How would retail customers be affected?

Standard Offer retail customers: In general, the APS proposal for a variance to the competitive bidding requirement appears to offer the following trade-off for standard offer customers. Standard offer customers would receive long-term price stability based on cost-of-service while foregoing the opportunity for standard offer prices to be driven downward by discounted generation purchases when supply is plentiful. Consequently, the effect on standard offer customers will be different from year-to-year. In a year in which generation supply is plentiful, standard offer prices are likely to wind up somewhat higher under the "APS variance proposal." In years in which a seller's market prevails (e.g., 2000 – Spring, 2001) standard offer customers would be better off with cost-of-service-based pricing because they would be insulated, to an extent, from extraordinary price spikes.

Beyond this general tradeoff, there are particular issues that will play a role in governing the effect on standard offer retail customers. For instance, the size of the bidding requirement (e.g. 50%) relative to the amount of generation available for bid is an important consideration. If the bidding requirement is set too high, it can have two negative effects for standard offer retail customers: (1) the market-clearing bid price would be set by the higher-cost producers, and (2) the volume of standard offer retail sales so priced by the higher-cost producers would be higher than would occur with a lower bidding requirement. If the bidding requirement is set too low, standard offer customers will be

deprived the benefits of competitive supply, and generators will be unfairly denied an opportunity to participate in the Arizona wholesale market as originally contemplated in the Competition Rule.

<u>Direct Access customers</u>: APS asserts that its Variance Proposal is not intended to affect Direct Access service. AECC concurs that Direct Access service is not directly affected by the APS proposal, so long as any implementation of that proposal did not become a vehicle to undermine any of the customer benefits achieved in the Settlement Agreement. (These benefits include the permanent eradication of stranded costs after 2004, and the right, with proper notice, to switch from Direct Access to Standard Offer service).

An argument can be made that Direct Access customers will be indirectly affected by the Variance Proposal if its adoption results in less generation being built in Arizona.

b. How would retail generation competition be affected?

As we stated above, AECC believes that Direct Access service is not directly affected by the APS proposal, so long as any implementation of that proposal does not become a vehicle to undermine customer benefits achieved in the Settlement Agreement. In general, if competitive bidding does not proceed, generation resources that end up not being committed to providing wholesale service to APS (e.g., in fulfillment of the bidding provision), would be available for sale to ESPs to be re-marketed to Direct Access retail customers.

Also as stated above, an argument can be made that Direct Access customers will be indirectly affected by the Variance Proposal if its adoption results in less generation being built in Arizona. This could occur if generation project developers are relying on the bidding provision in the Electric Competition Rules to economically justify continuing

their investments in Arizona. Alternatively, developers might consider a change in the Rules to be a negative "signal" relative to the state's (de)regulatory climate, and choose to discontinue development in response.

AECC believes it is most likely that in determining whether to proceed with generation investments, project developers will rely primarily on their projections of wholesale market prices and growth of aggregate regional demand, together with their assessment of transmission availability, project siting approval, and their ability to line up profitable long-term sales contracts. AECC believes these aforementioned factors will trump any decision the Commission makes with respect to competitive bidding.

c. How would wholesale generation competition be affected?

As stated above, an argument can be made that adoption of the APS Variance proposal would result in less generation being built in Arizona. This could occur if generation project developers are relying on the bidding provision in the Electric Competition Rules to economically justify continuing their investments. Alternatively, developers might consider a change in the Rules to be a negative "signal" relative to the state's (de)regulatory climate.

AECC believes it is most likely that in determining whether to proceed with generation investments, project developers will rely primarily on their projections of wholesale market prices and growth of aggregate regional demand, together with their assessment of transmission availability, project siting approval, and their ability to line up profitable long-term sales contracts. AECC believes these aforementioned factors will trump any decision the Commission makes with respect to competitive bidding.

1	2.	Are sufficient competitors available for an effective bidding
2		process for 50% of standard offer service? A higher or lower
3		percentage?
4	At this time,	AECC does not have sufficient information to determine whether then
5	are sufficient compet	itors for an effective bidding process for 50% of standard offer
6	service.	
7	3.	Can retail competition develop if current rules are modified to
8		allow a utility to procure all its generation for standard offer
9		service from an affiliated company?
10	Yes. While A	AECC supports the full package that emerged from the Settlement
11	Agreement (including	g the competitive bidding provisions), AECC does not view the
12	success of Direct Acc	cess service as being dependent on the implementation of competitive
13	bidding rules for stan	dard offer service. The bidding rules are more important for ensuring
14	competitive prices for	r standard offer service. The success of Direct Access service is more
15	directly related to the	delivered price of wholesale power relative to standard offer service
16	and the availability o	f non-discriminatory access to the transmission system for retail
17	transactions.	
18	4.	How would retail competition be affected by other deviations to
19		the competitive bid rules? Be specific about the changes in the
20		rules and their consequences.
21	AECC has no	t evaluated other deviations to the competitive bid rules.
22	5.	Instead of entertaining individual requests for substantial

variances to the competitive bid requirements, should the

Commission proceed on a generic basis to modify the rules for competitive bidding?

No. The burden with respect to seeking changes in this Rule should be on the party seeking the change. APS has come forward with a specific alternative plan that can be evaluated vis-à-vis the current Rule. AECC believes that in putting forward an alternative plan, APS has an obligation to ensure that customers retain the benefit of their Settlement Agreement bargain. If the Commission itself were to initiate a modification of the rules for competitive bidding, it would run the risk of upsetting the fundamental balance of interests achieved between customers and utilities in their respective settlement agreements.

(Example: The APS and TEP Settlement Agreements result in the elimination of stranded cost charges over time pursuant to fixed schedules. A Commission-led reevaluation of competitive bidding that resulted in a the establishment of new, long-term, cost-based contracts could lead to new arguments for extended stranded cost coverage.)

6. If the Commission would change the 50% bidding requirement for standard offer service, are there other specific measures the Commission can take to promote retail competition?

Yes. The Commission can reconfirm its support for the Arizona ISA, which, prior to the formation of an RTO, is necessary for ensuring access to the transmission system for retail transactions.

- D. Regarding the pricing of power supply contract rates --
 - Identify any advantages that would result if the Commission approved a long-term supply contract for standard offer customers that was based solely on cost-based rates. (Your

answer should define "long term" as compared with "short term" contract.)

The primary benefit to Standard Offer customers from such a contract would be long-term price stability based on cost-of-service. For example, during periods in which a seller's market prevails in wholesale markets (e.g., 2000 – Spring, 2001) Standard Offer customers would be insulated, to an extent, from significant upward price pressure. [For purposes of this discussion, AECC is viewing a long-term contract to be of 5 years' duration or longer. An intermediate-term contract would describe a contract less than 5 years, but greater than one year. A short-term contract would be one year or less in duration.]

2. What if the contracts are based solely on market-based rates?

Basing a long-term contract with an affiliate generator on market-based rates would seem to defeat the purpose of entering into such a contract in the first instance. That is, as argued by APS, the primary purpose of a long-term contract with an affiliate generator is to reduce the exposure of Standard Offer customers to market volatility. If a long-term contract is to be based on market prices, the service may as well be competitively bid as provided in the Rule, in order to allow other sellers an opportunity to provide the lowest bid and win the business.

3. Describe how FERC's new approach for analyzing the ability of sellers with market rate authority to exercise market power affects generation companies selling into Arizona.

AECC has not yet evaluated the implications of this new approach for Arizona.

4.	Does the Commission have the ability to assure that approval of
	a long-term contract would protect ratepayers receiving
	standard offer service as well as foster competition?

Yes. To the extent that the Commission ensures that the terms and conditions of any long-term contract are fair and reasonable, the interests of standard offer customers can be protected. In addition, in the proposal put forward by APS, there is an important natural "cap" on the ability of the utility to pass through unreasonable costs in its long-term contract: namely, the existence of the competitive shopping option (without the burden of stranded costs after 2004). For this reason, if the APS Proposal were adopted, it would be particularly important for all customers to retain their right to shop.

To foster competition, it is important to ensure that the rights of Direct Access customers established in the Competition Rules and Settlement Agreements are preserved.

V. Industry Events External to Arizona

- A. Describe in detail developments you believe will occur in both the wholesale and retail competitive electric generation markets nationally and in Arizona over the next 12 months, 24 months, 36 months, 48 months and 60 months.
 - In the next year: FERC will continue to press for RTO formation and will make some determination regarding the WestConnect application. As wholesale prices stabilize, we expect to see increased interest in Direct Access opportunities in Arizona. An additional 3400 MW of generation is

1	scheduled to come on line in Arizona. In other parts of the west, Direct
2	Access will go forward in Oregon, Washington, and Nevada.
3	• In two years, Arizona customers will have a greater number of ESPs bidding
4	for their business. Stranded cost charges are scheduled to terminate in the
5	SRP territory by June 2004, and APS regulatory assets are scheduled to be
6	amortized by June 2004, reducing the cost of Direct Access service. Another
7	5600 MW of generation is scheduled to come on line in Arizona.
8	• In three years an RTO should be operational in Arizona. The APS stranded
9	cost charge is scheduled to be terminated effective January 2005.
10	B. Is there anything the Commission should do to continue to avoid
11	California's retail electric competition experience? Please be specific.
12	Yes. The Commission should bear in mind that retail competition was a casualty of
13	the California debacle - not the cause. The cause was related to the structure of California's
14	wholesale market, which forced standard offer resource procurement to take place on the
15	spot market (during a period of capacity scarcity). AECC recommends the following:
16	 Focus on bottom line standard offer results within the framework of the
17	Competition Rules, but without micro-managing the resource acquisition
18	practices of the standard offer provider.
19	 Do not require resource procurement from spot markets.
20	• Encourage utilities with standard offer customers to hedge wholesale costs.
21	 Continue to allow customers to take direct access service.
22	 Avoid undue regulatory obstacles to generation and transmission
23	development.

C. Does the Enron bankruptcy have any lesson for retail electric competition in Arizona?

Supplies of electricity and natural gas have continued unabated since announcement of the Enron bankruptcy. The absence of Enron from these markets has increased the possibility of higher market share for existing and future competitors. The loss of Enron Online, a web-based wholesale energy trading platform, did temporarily result in a reduction in market liquidity which has since been remedied by migration of wholesale transactions to other trading systems and goes on largely unaffected.

The lesson learned by many retail providers, whose generation portfolio contained supply contracts with Enron, emphasizes a previously understood principle to manage a supply portfolio that is not unduly reliant on any one provider, trader, generator, or marketer. Some industry analysts expect that the potential losses to energy suppliers, due to myriad contracts now in limbo due to the Enron bankruptcy, will refocus the industry's risk management practices and result in more balanced and stable supply portfolios for retail energy suppliers.

As the Enron failure relates specifically to retail customers, one lesson learned is that Direct Access customers should be protected both by regulation and contract. Relative to regulation, competition rules should not impede a customer's return to the competitive market should their supplier terminate a contract due to bankruptcy. Relative to contract, competition rules should permit the assignment of contracts from one supplier to another (with the customer's permission) without any restriction imposed by rule or regulation. From time to time, and specifically in the case of a retail provider bankruptcy, Arizona retail customers should be allowed to confidently rely on contract assignment provisions,

so long as the assignee is a certificated retail service provider under the Commission's rules and in accordance with Arizona law. This precise issue has come to the fore in California where Enron customers are not at all sure that their previous contracts with Enron, which allowed for assignment, will be upheld. The result is that many former Enron customers are at risk of return to utility service at the highest rates ever charged for electric service in California, with no hope of future access to the competitive market.

D. How will FERC's RTO initiative affect the realization of effective retail generation competition in Arizona?

The FERC's RTO initiative will be helpful to the realization of effective retail competition in Arizona because it will provide for the elimination of pancaked tariffs (thereby increasing the customer's viable generation options) and will ensure functional separation of transmission. Another area of promise is congestion management — although whether this function is managed in a way supportive of retail competition depends on the specific proposal adopted by an RTO. The congestion management protocols filed at FERC by WestConnect *are* helpful to Direct Access because the ultimate congestion management "rights" reside with load, and are not permanently parceled out to individual market participants.

E. Do you anticipate changes in federal utility statutes to affect the jurisdiction of the Commission and its ability to foster retail competition in Arizona? Please detail.

AECC is not aware of such changes.

VI. System Security

5.

1		17	he subject matter of the questions in this section is outside the expertise of
2		AEC	
3			
4		A.	Are there compelling reasons to be concerned about security for electric
5.			generation facilities since the Sept 11, 2001 tragedy? Please include
6			discussion of interconnection at a central location such Palo
7		В.	Does transferring ownership of generation facilities out from traditional
8			Commission jurisdiction have any potential negative security
9			consequences?
10		C.	What if ownership after transfer results in a foreign corporation
11			eventually controlling Arizona's generation?
12		D.	Does such a transfer to a non-Arizona entity potentially impact security
13			issues for Arizona?
14	- 1 - 1 - 1 - 1 - 1 - 1 - 1 - 1 - 1 - 1	E.	Are there any positive security aspects to transferring electric
15			generation out from Commission traditional regulation to a foreign
16			corporation?
17		F.	Provide specific examples to support your answers.
18			
19	VII.	Vision	
20		Please	e provide your vision for how viable competitive wholesale <u>and</u> retail
21	·)	electr	ic markets will (or will not) develop in Arizona. Please be specific
22		regar	ding dates, the development process, and measures for determining at
23		vario	is states how successful the process has been.

After a period of significant disruption, wholesale competition is back on track. We believe the prospects for wholesale competition will improve as RTO development proceeds and the new "rules of the road" for transmission scheduling, congestion management, and transmission planning are established. The primary metrics for measuring the success of wholesale competition are: (1) How closely do wholesale prices correspond to long-run marginal cost?, and (2) Do real long-run marginal costs decline over time due to innovation and efficiency improvement?

We believe that retail competition will become more viable as: (1) forward wholesale prices become more competitive with the standard offer, and (2) stranded cost charges are terminated as scheduled. This viability is predicated on fair and efficient access to the wires for retail transactions. This requires either an RTO to be operational or an interim substitute to be in place, i.e., Arizona ISA.

The key operative word in this vision is customer CHOICE. The first level of choice is between standard offer service and Direct Access service. AECC supports the retention of the standard offer option for any customer who elects not to shop in the competitive market. Similarly, the option to shop in the competitive market should be retained for all customers. That represents the choice all Arizona customers have today. It is the choice all Arizona customers should have tomorrow as well.

Whereas during the formulation stages of the Competition Rules there was a great deal of concern over the utilities being inundated by a flood of requests to switch providers, due to the recent experience with very high wholesale prices, the opposite has occurred.

Customers have either remained on, or returned to, the standard offer. Consequently, we

expect the return to Direct Access service to be a gradual one, allowing for an orderly transition.

3 '

The success of retail competition can be measured a number of ways. One obvious way is to measure the number of customers who elect to take Direct Access service. Final judgment in this regard should not be made until stranded cost charges are paid off.

Perhaps the best overall measure is the price customers pay for power. In this regard,

Arizona's customer choice program has been successful even during the past period of high wholesale prices, despite little or no Direct Access activity. Arizona's customer choice program permitted the choice of standard offer service at stable rates, while not interfering in the utilities' ability to make the resource acquisition decisions necessary to deliver the bargained-for rates. With dramatic rate increases being imposed or under consideration in Nevada, California, Oregon, and Washington – Arizona stands out as an island of retail price stability. And with new generation coming on line, Arizona is well-positioned to enjoy rate stability in the future.

SUPPLEMENTAL OUESTIONS FROM CHAIRMAN MUNDELL

1 2

The corporate structure analysis required by these questions is outside the expertise of AECC at this time.

QUESTIONS FROM COMMISSIONER SPITZER

1. In a vertically integrated utility model, what incentives (regulatory, financial, and ratemaking) exist for the expanded use of renewable energies?

The first incentive is economic: Is the technology competitive with the least-cost alternatives? In the case of hydropower, the answer has often been yes. If, however, the answer is "no," then the regulated utility will seek to ensure that any renewable energy expenditures undertaken in support of regulatory directives are recoverable in rates. These costs are then added into rate base and operating expenses (as appropriate) in the determination of the utility's revenue requirements. A variation of this approach is the levying of a renewable energy surcharge that is earmarked for funding renewable energy expenditures, as in the Environmental Portfolio Standard currently in force in Arizona.

2. In a competitive electric market model, what incentives exist for the expanded use of renewable energies?

Again, the first incentive power producers will look for is economic. Some renewable development could fit into this category in fulfillment of a green power market niche. Unlike the regulatory model, however, to the extent that economic signals do not support renewable energy development, the "rate base" option is not available. The

I	surcharge/subsidy approach that can be adopted in a vertically-integrated model, may also		
2	be used in a competitive model, as has been required in Arizona.		
3	3. In a vertically integrated utility model, what disincentives (regulatory,		
4	financial, and ratemaking) exist for the expanded use of renewable		
5	energies?		
6	The primary disincentive is economic. For some technologies, there is also a		
7	potential disincentive with respect to unit availability (i.e., capacity). For example, a wind		
8	farm may be a source of energy (MWH) when the wind is blowing, but may not be		
9	considered a reliable source of capacity (MW) if the site is prone to a significant number of		
10	days when the resource is unavailable. Another possible disincentive is concern that		
11	investments made on the basis of a subsidy will lead to additional "stranded cost" at some		
12	future date if the subsidy is removed.		
13	4. In a competitive electric market model, what disincentives exist for the		
14	expanded use of renewable energies?		
15	Please see response to 3, above.		
16	5. During Arizona's period of reliance on the vertically integrated utility		
17	model, what renewable energy programs were enacted in Arizona?		
18	AECC has not had the opportunity to research a response to this question.		
19	6. Since Arizona's adoption of a competitive market model, what		
20	renewable energy programs have been enacted in Arizona?		
21	AECC has not had the opportunity to research a full response to this question, but is		
22	aware of the Commission's adoption of the Environmental Portfolio Standard to support		

renewable technologies.

7. Under the vertically integrated utility model, what incentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

All things being equal, there is not a lot of incentive to do this unless the new plant can be put into rate base; to get a new plant into rate base generally requires the filing of a rate case, a rather infrequent occurrence in Arizona.

8. Under the competitive electric model, what incentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

Generally, competitive generators would not build new plants for the express purpose of replacing older, dirtier plants. However, more inefficient power plants are generally more costly to operate than modern, energy-efficient plants, and, as generation supply increases due to competition, inefficient plants are likely to be "out of the money" on an increasingly-frequent basis. Note that this general tendency is sometimes offset by specific circumstances, such as "must-run" conditions, in which a plant's location on the grid makes it necessary for it to operate for reliability reasons, even at costs that are above market.

9. Under the vertically integrated utility model, what disincentives (regulatory, financial, and ratemaking) exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

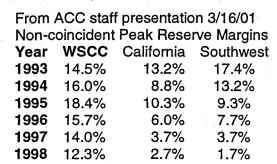
Generally, older plants have the advantage of being heavily depreciated and therefore cost little in rate base. In addition, their typically-higher operating costs are fully recovered as an operating expense in rates. It is also not unusual for an older plant to have a locational advantage on the transmission system, in which it provides voltage support

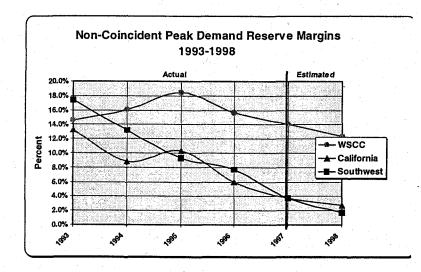
1	and/or relief from load pocket congestion. Truly "replacing" the plant may mean having to		
2	construct a new one at the same location, an undertaking that may be problematic.		
3 _{2 2}	3 Under the competitive electric market model, what disincentives exis		
4	to build newer plants that are less damaging to the environment to		
5	replace older, dirtier plants?		
6	AECC is not aware of any disincentives.		
7	11. During Arizona's period of reliance on the vertically integrated utility		
8	model, what emphasis has the Commission placed on pollution control		
9	measures in Certificates of Environmental Compatibility?		
10	(a) What is the most stringent pollution control measure placed on a		
11	CEC during Arizona's reliance on the vertically integrated utility		
12	model?		
13	AECC has not had the opportunity to research the response to this question.		
14	12. Since Arizona's adoption of a competitive market model, what		
15	emphasis has the Commission placed on pollution control measures in		
16	Certificates of Environmental Compatibility?		
17	(b) What is the most stringent pollution control measure placed on a		
18	CEC since Arizona's adoption of a de-regulated utility model?		
19	(c) What is the likelihood that that measure would have been placed on		
20	a similar CEC in a vertically-integrated utility model?		
21	AECC has not had the opportunity to research the responses to this question.		
22	13. During Arizona's period of reliance on the vertically integrated utility		
23	model, what amount of excess generating capacity existed in Arizona?		

Arizona's vertically integrated utilities, like most western utilities, experienced a considerable "bubble" of excess generating capacity for many years. In recent years, the capacity bubble contracted substantially with growth in demand.

The trend in excess capacity has been documented by the WSCC and subsequently by Commission staff in a March 2001 presentation. As shown in the table and chart below, reserve margins have dropped steadily in the region and in Arizona.

3.





The U.S. EIA reports that Arizona-based generation capacity increased 1.7% from 1990 to 1999, while Arizona-based demand for the same period grew 28%. During the same period, megawatt-hour production from Arizona generation facilities increased 25%. In short, the growth in demand appears to have been managed by increases in capacity factor of existing plants (not accounting for sales to out of state marketers or utilities), as well as contract purchases, with practically no capacity additions.

14. Since Arizona's adoption of a competitive market model, what amount of excess generating capacity existed in Arizona?

1 .	Little or none. For example, APS projected in its Energy Outlook Presentation on
2	May 3, 2001 that in 2001, over 22% of their expected summer peak load of 5,793mW
3	(including 12% reserve margin) was to be covered by purchases and contracts. This
4	shortfall covered by third-party generation is consistent with the reduction in the
5	Arizona/Western capacity bubble.

QUESTIONS FROM COMMISSIONER IRVIN

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1.	Please address whether Arizona's Constitution prohibits the Commission from giving up any authority with respect to the pricing of			
	services by public service corporations, which occur solely within the			
	state.			

AECC has not had the opportunity to conduct the legal analysis to address this question in the context in which it was asked.

2. Should Arizona be willing to let the federal government take over pricing jurisdiction (market-based rates) for all retail transactions which occur in the state, or is this an inevitable (and proper) result of opening retail markets to competition?

Strictly speaking, AECC does not foresee that FERC would take over pricing jurisdiction for *any* retail generation service transactions that occur in the state. Such transactions, both standard offer and Direct Access, would still be under the purview of the Commission pursuant to the Competition Rules. However, a market-purchase requirement for the provision of standard offer service would increase the amount of retail service in Arizona that originated from wholesale market purchases (as opposed to being provided by a vertically-integrated utility), and these wholesale purchases would properly be subject to FERC jurisdiction.

3. Can Arizona's UDCs modify their tariffs with the FERC to conform with AISA protocols so that retail transactions can still take place

without the AISA? How many times has the AISA been used to resolve disputes over transmission issues to date?

Any such modification raises several concerns: (1) To take effect, it would have to be approved by FERC. In the past, FERC has been unwilling to accept such modifications except as part of the AISA. (2) Even if approved by FERC, such an arrangement would lack the forum provided by the AISA for making protocol modifications to address any changed conditions and would likely lead to different protocols being employed in different utility territories. (3) Future retail access activity may lead to a need for protocol interpretation to resolve disputes. The AISA provides this function.

To date, due to the lack of retail access activity during 2000-01, we are not aware of any transmission dispute resolution performed by the AISA.

4. If the majority of market participants intend to market electricity only to industrial, large commercial and load serving ESPs entities, should retail markets be limited by load size to allow those entities with true bargaining power to negotiate Direct Access?

AECC does not believe that customer "bargaining power" should be determined or limited by fiat. All Arizona customers should retain the right to shop.

- 5. What will be a UDC's primary functions in a competitive market?

 The primary role of a UDC in a competitive market is to provide

 distribution service, default revenue cycle services, and standard offer service.
- 6. Is it important to first establish functional wholesale markets before creating robust retail markets in electric generation? If so, why? If not, why?

The more robust are wholesale markets, the better retail markets will perform.

However, degree of robustness is a matter of opinion. Even if some believe wholesale markets are imperfect, that is not a good reason to limit customer choice in Arizona, because Arizona customers retain the right to choose standard offer service. Customers can decide for themselves whether they believe the wholesale market is sufficiently functional to warrant taking Direct Access service.

7. When price caps are lifted for the majority of Arizona consumers, what assurances do we have that volatility in the market (for both natural gas and electricity) will not result in unstable or inflated rates? Will the general price of electricity fluctuate with the price of natural gas?

There are no price guarantees in competitive markets. The best assurance for reasonable price levels is to encourage generation supply from a variety of producers, and promote needed transmission construction and RTO development, as well as needed additions to pipeline capacity.

Because generation from natural gas power plants is likely to be the energy production that is on the margin, natural gas prices will play an important role in influencing electricity prices in the West.

8. Should there be a provision added to R14-2-1606(B) which would allow/limit a UDC to contract for wholesale power in three or five year intervals? What would be a proper length for contracts?

AECC believes that the current provisions do not preclude 3-5 year contracts. In general, standard offer providers should seek to hold a portfolio of contracts of differing

1	lengths. While the prudence of contracting decisions would be subject to Commission		
2	review, the Commission should not legislate contract length a priori.		
3	9. What are the real benefits to residential consumers and small		
4	businesses in retail competition, other than consumer choice? Will IPPs		
5	market their power directly to retail customers, or are their efforts		
6	mainly focused on selling power to wholesale customers?		
7,	Consumer choice is a real benefit. In addition, generation competition should lower		
8	the long-run cost of production, from which all customers will benefit. It will also shift		
9	project development risk and capital costs to investors, benefiting all customers. Moreover,		
10	competition will encourage the construction of plants that are energy efficient, thereby		
11	conserving natural resources.		
12	Under current federal and state regulations, IPPs cannot market power directly to		
13	retail customers. IPPs will sell to wholesale customers, which includes ESPs. Direct Access		
14	generation sales to retail customers will be from ESPs.		
15	10. Currently, is residential choice a real option? If not now, when?		
16	Currently, residential choice does not appear to be an economic option in Arizona.		
17	It may become more viable after stranded cost charges are paid off.		
18	11. What provisions, if any, are necessary to effectuate a gradual		
19	replacement of those existing plants in Arizona which are older, more		
20	polluting and less efficient than the newer combined cycle plants		
21	currently being built?		

modern, energy-efficient plants, as generation supply increases due to competition,

Because more inefficient power plants are generally more costly to operate than

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inefficient plants are likely to be "out of the money" on an increasingly-frequent basis.

Note that this general tendency is sometimes offset by specific circumstances, such as "must-run" conditions, in which a plant's location on the grid makes it necessary for it to operate for reliability reasons, even at costs that are above market.

12. What re the long-term effects of divestiture for APS? How does the Commission guard against a PG&E situation, where the distribution company declares bankruptcy after profits have flowed to its parent holding company?

By "divestiture," AECC assumes the question is referring to the required APS spinoff of its Genco. The long-term effects will likely differ depending on decisions made in
the upcoming proceeding regarding the relationship between APS and its Genco affiliate.

If a straight spin-off proceeds as planned, one issue that may come to the fore (after 2004)
is whether Pinnacle West has too much market power in the Arizona market. (A finding
that too much market power was present could lead to FERC-regulated cost-based pricing.)
AECC is encouraged by the new generation construction that is occurring, which will
mitigate this potential problem.

Arizona has successfully avoided the PG&E situation by taking a very different route to restructuring. In part, this is due to focusing on bottom line standard offer results while not over-constraining or micro-managing the standard offer provider.

. 1	RESPECTFULLY SUBMITTED this 25	th day of February, 2002.
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3		
3		011-5 11
4		Ohl T. Stenn
5		Charles T. Stevens
6		Attorney for Arizonans for Electric Choice
7		and Competition
8		245 W. Roosevelt
9		Phoenix, AZ 85003
10		(602) 229-1010
11		(002) 223 1010
12	Original and ten (10) copies of the foregoing	
13	filed this 25 th day of February, 2002, with:	
14	inod this 25 day of Footdary, 2002, with.	
15	Docket Control Division	
16	Arizona Corporation Commission	
17	1200 West Washington Street	
18	Phoenix, Arizona 85007	
	Filoelita, Arizolia 65007	
19		
20		
20		
3 1	Copies of the foregoing were mailed/delivered th	is 25th day of Echmany 2002 to the attack of
21	service list.	is 25 day of February 2002 to the attached
22	service list.	
23		
~ .		
24	•	
25		

1		DOCKET NO. E-01933A-02-00
	Walter W. Meek, President	CONTINENTAL DIVIDE ELECTRIC
2	ARIZONA UTILITY INVESTORS	COOPERATIVE
	ASSOCIATION	P.O. Box 1087
3	2100 N. Central Avenue, Suite 210	Grants, New Mexico 87020
	Phoenix, Arizona 85004	•
4	and the state of t	DIXIE ESCALANTE RURAL ELECTRIC
. 7	Rick Gilliam	ASSOCIATION
5	Eric C. Guidry	CR Box 95
)	LAND AND WATER FUND OF THE	Beryl, Utah 84714
]	ROCKIES	
6	ENERGY PROJECT	GARKANE POWER ASSOCIATION, INC.
_	2260 Baseline Road, Suite 200	P.O. Box 790
7	Boulder, Colorado 80302	Richfield, Utah 84701
	Dodder, Colorado 50302	Eddinadon, Ottar O., U.
8	Terry Frothun	ARIZONA DEPT OF COMMERCE
- !	ARIZONA STATE AFL-CIO	ENERGY OFFICE
9	5818 N. 7th Street, Suite 200	3800 North Central Avenue, 12th Floor
	Phoenix, Arizona 85014-5811	Phoenix, Arizona 85012
10	TROUBLE PULLONG 05014-5017	Thousand an around 600 12
	Norman J. Furuta	Christopher J. Emge
11	DEPARTMENT OF THE NAVY	ARIZONA COMMUNITY ACTION ASSOC.
12	900 Commodore Drive, Building 107	2627 N. 3rd Street. Suite 2
12	San Bruno, California 94066-5006	Phoenix, Arizona 85004
12	Barbara S. Bush	THICKON ELECTRIC BOWER CO
1.5	COALITION FOR RESPONSIBLE ENERGY	TUCSON ELECTRIC POWER CO.
14		Legal Dept – DB203 220 W 6 th Street
14	EDUCATION	
	315 West Riviera Drive	P.O. Box 711
15	Tempe, Arizona 85252	Tucson, Arizona 85702-0711
	Same Defence (Attn. Code 001)	A.D. Doordoon
16		A.B. Baardson
	Rate Intervention Division	NORDIC POWER
17	NAVAL FACILITIES ENGINEERING	4281 N. Summerset
	COMMAND	Tucson, Arizona 85715
18	Building 212, 4th Floor	
	901 M Street, SE	Jessica Youle
19	Washington, DC 20374-5018	PAB300
		SALT RIVER PROJECT
20	Rick Lavis	P.O. Box 52025
	ARIZONA COTTON GROWERS	Phoenix, Arizona 85072-2025
21	ASSOCIATION	
21	4139 East Broadway Road	Joe Eichelberger
22	Phoenix, Arizona 85040	MAGMA COPPER COMPANY
22		P.O. Box 37
~~	Steve Brittle	Superior, Arizona 85273
23	DON=T WASTE ARIZONA, INC.	
	6205 South 12th Street	Craig Marks
24	Phoenix, Arizona 85040	CITIZENS UTILITIES COMPANY
		2901 N. Central Avenue, Suite 1660
25	COLUMBUS ELECTRIC COOPERATIVE,	Phoenix, Arizona 85012-2736
	INC.	· · · · · · · · · · · · · · · · · · ·
26	P.O. Box 631	
a	Deming, New Mexico 88031	
27	Solidary, From Interaction Control	

69(

		DOCKET NO. E-01933/	A- 02-00
ii	Barry Huddleston	C. Webb Crockett	
	DESTEC ENERGY	Jay L. Shapiro	1
- (P.O. Box 4411	FENNEMORE CRAIG. PC	
3	Houston, Texas 77210-4411	3003 N. Central Avenue, Suite 2600	
, [Fibilition, Toans / 1210-4411	Phoenix, Arizona 85012-2913	
.]	Stove Montgomery	The second secon	
4	Steve Montgomery JOHNSON CONTROLS		
11			
5	2032 West 4th Street	Robert S. Lynch	
	Tempe, Arizona 85281	340 E. Palm Lane, Suite 140	
6		Phoenix, Arizona 85004-4529	
	Terry Ross		
7	CENTER FOR ENERGY AND	Attorney for Arizona Transmission Dependent	
	ECONOMIC DEVELOPMENT	Utility Group	
8	P.O. Box 288		
	Franktown, Colorado 80116-0288	K.R. Saline	
9		K.R. SALINE & ASSOCIATES	
7	Clara Peterson	Consulting Engineers	
	AARP	160 N. Pasadena, Suite 101	
10	HC 31, Box 977	Mesa, Arizona 85201-6764	
	Happy Jack, Arizona 86024		
11	i i i i i i i i i i i i i i i i i i i	Cari Robert Aron	
	Larry McGraw	Executive Vice President and COO	
12	USDA-RUS	ITRON, INC.	
	6266 Weeping Willow	2818 N. Sullivan Road	
13		Spokane, Washington 99216	
10	Rio Rancho, New Mexico 87124	Spokane, washington 97210	
	N. B. C. M.	Davidos Malas	
14	Jim Driscoll	Douglas Nelson	
	ARIZONA CITIZEN ACTION	DOUGLAS C. NELSON PC	
15	5160 E. Bellevue Street, Apt, 101	7000 N. 16th Street, Suite 120-307	
	Tucson, AZ 85712-4828	Phoenix, Arizona 85020-5547	
16		Attorney for Calpine Power Services	
-	William Baker		
17	ELECTRICAL DISTRICT NO. 6	Lawrence V. Robertson Jr.	
. ,	P.O. Box 16450	MUNGER CHADWICK, PLC	
18	Phoenix, Arizona 85011	333 North Wilmot, Suite 300	
10		Tucson, Arizona 85711-2634	
	John Jay List	Attorney for PG&E Energy Services Corp	
19	General Counsel		
	NATIONAL RURAL UTILITIES	Albert Sterman	
20	COOPERATIVE FINANCE CORP.	ARIZONA CONSUMERS COUNCIL	
21	2201 Cooperative Way	2849 East 8th Street	
~.	Herndon, Virginia 21071	Tucson, Arizona 85716	
22			
2.	Robert Julian	Michael Grant	
~~	PPG	GALLAGHER & KENNEDY	
23	1500 Merrell Larie	2575 East Camelback Road	
	Beigrade, Montana 59714	Phoenix, Arizona 85016-9225	
24		Attorneys for AEPCO, Graham County Electric	
		Cooperative, and Duncan Valley Electric	
25		Cooperative.	
		•	
26	,		
27	,		

1		DOCKET NO. E-01933A-
	Suzanne Dallimore	Andrew Bettwy
2	Antitrust Unit Chief	Debra Jacobson
	Department of Law Building	SOUTHWEST GAS CORPORATION
3	ARIZONA ATTORNEY GENERAL'S	5241 Spring Mountain Road
.,	OFFICE	Las Vegas, Nevada 89150-0001
,	1275 West Washington Street	
4	Phoenix, Arizona 85007	Barbara R. Goldberg
ا ہ	Process, Adams 6500)	OFFICE OF THE CITY ATTORNEY
5	Vinnie Hunt	3939 Civic Center Blvd.
	CITY OF TUCSON	Scottsdale, Arizona 85251
6	Department of Operations	
_	4004 S. Park Avenue, Building #2	Bradford A. Borman
7	Tucson, Arizona 85714	PACIFICORP
	Lucsoit, Alizona 05/14	201 S. Main, Suite 2000
8	Elizabeth S. Firkins	Salt Lake City, Utah 84140
	INTERNATION BROTHERHOOD OF	A STATE OF THE PARTY OF THE PAR
9	ELECTRICAL WORKERS, L.U. #1116	Timothy M. Hogan
	750 S. Tucson Blvd.	ARIZONA CENTER FOR LAW
10	Tucson, Arizona 85716-5698	IN THE PUBLIC INTEREST
	1 LCSON, ATIZONA 65710-5076	202 E. McDowell Rd., Suite 153
11	Carl Dabelstein	Phoenix, Arizona 85004
- !	2211 E. Edna Avenue	THOUSE, THEOLEGOOOT
12	Phoenix, Arizona 85022	Marcia Weeks
	I ROCITA, ALIZONA 65022	18970 N. 116th Lane
13	Roderick G. McDougall, City Attorney	Surprise, Arizona 85374
•	CITY OF PHOENIX	outproof international t
14		John T. Travers
•	200 W Washington Street, Suite 1300	William H. Nau
15	Phoenix, Arizona 85003-1611	272 Market Square, Suite 2724
1.5		Lake Forest, Illinois 60045
16	William J. Murphy	
10	CITY OF PHOENIX	Timothy Michael Toy
17	200 West Washington Street, Suite 1400	WINTHROP, STIMSON, PUTNAM & ROBERTS
17	Phoenix, Arizona 85003-1611	One Battery Park Plaza
18		New York, New York 10004-1490
10	Russell E. Jones	
19	WATERFALL ECONOMIDIS CALDWELL	Raymond S. Heyman
19	HANSHAW & VILLAMANA, P.C.	Michael W. Patten
20	5210 E. Williams Circle, Suite 800	ROSHKA HEYMAN & DEWULF, PLC
20	Tucson, Arizona 85711	400 E. Van Buren, Suite 800
~ 1	Attorneys for Trico Electric Cooperative, Inc.	Phoenix, Arizona 85004
21		Attorneys for Tucson Electric Power Co.
	Christopher Hitchcock	
22	HITCHCOCK & HICKS	Chuck Miessner
	P.O. Box 87	NEV SOUTHWEST LLC
23	Bisbee, Arizona 85603-0087	P.O. Box 711, Mailstop-DA308
	Attorney for Sulphur Springs Valley	Tucson, Arizona 85702-0711
24	Electric Cooperative, Inc.	
	-	Billie Dean
25		AVIDD
		P O Box 97
26		Marana, Arizona 85652-0987

-0069

1		DOCKET NO. E-01933A-02-
. 1	Raymond B. Wuslich	Stephen L. Teichler
2	WINSTON & STRAWN	Stephanie A. Conaghan
_ {	1400 L Street, NW	DUANE MORRIS & HECKSCHER, LLP
3	Washington, DC 20005	1667 K Street NW, Suite 700
		Washington, DC 20006
4	Steven C. Gross	
	PORTER SIMON	Kathy T. Puckett
5	40200 Truckee Airport Road	SHELL OIL COMPANY
	Truckee, California 96161-3307	200 N. Dairy Ashford
6	Attorneys for M-S-R Public Power Agency	Houston, Texas 77079
_	Donald R. Allen	Andrew N. Chau
7	John P. Coyle	SHELL ENERGY SERVICES CO., LLC
اہ	DUNCAN & ALLEN	1221 Lamar. Suite 1000
8	1575 Eye Street, N.W.,, Suite 300	Houston, Texas 77010
_	Washington, DC 20005	
9		Peter Q. Nyce, Jr.
	Ward Camp	DEPARTMENT OF THE ARMY
10	PHASER ADVANCED METERING	JALS-RS Suite 713
	SERVICES	901 N. Stuart Street
11	400 Gold SW, Suite 1200	Arlington, Virginia 22203-1837
10	Albuquerque, New Mexico 87102	
12		Michelle Ahlmer
	Theresa Drake	ARIZONA RETAILERS ASSOCIATION
13	IDAHO POWER COMPANY	224 W. 2 nd Street
1.4	P.O. Box 70	Mesa, Arizona 85201
14	Boise, Idaho 83707	Den Neidlinger
1.5	Libby Devidelf	Dan Neidlinger NEIDLINGER & ASSOCIATES
15	Libby Brydolf CALIFORNIA ENERGY MARKETS	3020 N. 17 th Drive
16	NEWSLETTER	Phoenix, Arizona 85015
16	2419 Bancroft Street	i nochia, rationa 65015
17	San Diego, California 92104	Chuck García
1 /	5 10g0, 0 minut	PNM, Law Department
10	Paul W. Taylor	Alvardo Square, MS 0806
18	R W BECK	Albuquerque, New Mexico 87158
19	2201 E. Camelback Rd Suite 115-B	•
19	Phoenix, Arizona 85016-3433	Sanford J. Asman
20		570 Vinington Court
20	James P. Barlett	Dunwoody, Georgia 30350-5710
21	5333 N. 7th Street, Suite B-215	
21	Phoenix, Arizona 85014	Patricia Cooper
22	Attorney for Arizona Power Authority	AEPCO/SSWEPCO
ت د		1000 South Highway 80
23	Jay I. Moyes	Benson, Arizona 85602
وي	MOYES STOREY	Stave Cogni
24	3003 N. Central Ave., Suite 1250	Steve Segai LEBOEUF, LAMB, GREENE, & MACRAE
4-7	Phoenix, Arizona 85012	633 17 th Street, Suite 2000
25	-	Denver, Colorado 80202-3620
ريد		Doniver, Coloniad Colonial
26		

A-02-0069

		BARTON DALOS
1.		DOCKET NO. E-01933A
	Holly E. Chastain	Patrick J. Sanderson
2	SCHLUMBERGER RESOURCE	ARIZONA INDEPENDENT SCHEDULING
. [MANAGEMENT SERVICES, INC.	ADMINISTRATOR ASSOCIATION
3	5430 Metric Place	P.O. Box 6277
	Norcross, Georgia 30092-2550	Phoenix. Arizona 85005-6277
4		
	Leslie Lawner	Roger K. Ferland
5	ENRON CORP	QUARLES & BRADY STREICH LANG, L.L.P.
- 1	712 North Lea	Renaissance One
6	Roswell, New Mexico 88201	Two North Central Avenue
		Phoenix, Arizona 85004-2391
7	Alan Watts	
	Southern California Public Power Agency	Charles T. Stevens
8	529 Hilda Court	ARIZONANS FOR ELECTRIC CHOICE &
٥	Anaheim, California 92806	COMPETITION
9	and the same of th	245 W. Roosevelt
9	Frederick M. Bloom	Phoenix, Arizona 85003
10	Commonwealth Energy Corporation	;
10	15991 Red Hill Avenue. Suite 201	Mark Sirois
	Tustin, California 92780	ARIZONA COMMUNITY ACTION ASSOC.
11		2627 N. Third Street, Suite 2
	Margaret McConneli	Phoenix, Arizona 85004
12	Maricopa Community Colleges	
	2411 W. 14 th Street	Jeffrey Guldner
13	Tempe, Arizona 85281-6942	Thomas L. Mumaw
		SNELL & WILMER
14	Chris King	400 E. Van Buren,
	UTILITY.COM INC.	One Arizona Center
	828 San Pablo Avenue, Suite 115	Phoenix. Arizona 85004-0001
	Albany, California 94706	
16		Steven J. Duffy
	Brian Soth	RIDGE & ISAACSON PC
17	FIRSTPOINT SERVICES, INC.	3101 N. Central Avenue, Suite 740
	1001 S.W. 5th Ave. Suite 500	Phoenix, Arizona 85012
18	Portland, Oregon 92704	Con a Postanoan
	v 0.85	Greg Patterson
19	Ian Calkins	5432 E. Avaion
	PHOENIX CHAMBER OF COMMERCE 201 N. Central Ave., 27th Floor	Phoenix, Arizona 85018
20		John Wallace
	Phoenix, Arizona 85073	Grand Canyon State Electric Co-op
21	Kevin McSpadden	120 N. 44 th Street, Suite 100
	MILBANK, TWEED, HADLEY AND	Phoenix, Arizona 85034-1822
22	MCCLOY, LLP	Frocina, Arizona 65054-1622
	601 S. Figueroa, 30th Floor	Steven Lavigne
23	Los Angeles, California 90017	DUKE ENERGY
	LOS AIIXCICS, CARROLINA 700 L/	4 Triad Center, Suite 1000
24	M.C. Arendes, Jr.	Salt Lake City, Utah 84180
-	C3 COMMUNICATIONS, INC.	Sait Lane City, Otali 04100
25	2600 Via Fortuna, Suite 500	Dennis L. Delaney
J	Austin, Texas 78746	K.R. SALINE & ASSOC.
26	rustin, Texas 70740	160 N. Pasadena, Suite 101
2.0		Mesa, Arizona 85201-6764
27		TANDER AND THE COMPANY OF THE COMPAN
41		

DOCKET NO. E-01933A-02-0069

Christopher Kempley, Chief Counsel ARIZONA CORPORATION COMMISSION 1200 W. Washington Street Phoenix, Arizona 85007

Ernest G. Johnson, Utilities Division ARIZONA CORPORATION COMMISSION 1200 West Washington Street Phoenix, Arizona 85007

ARIZONA REPORTING SERVICE, INC. 2627 N. Third Street, Suite Three Phoenix, Arizona 85004-1104

Michael A. Curtis
MARTINEZ & CURTIS, P.C.
2712 North 7th Street
Phoenix, Arizona 85006
Attorneys for Arizona Municipal Power Users>
Association, Mohave Electric Cooperative, Inc. &
Navopache Electric Cooperative. Inc.

Lindy Funkhouser Scott S. Wakefield RUCO 2828 N Central Ave, Suite 1200 Phoenix, Arizona 85004

Kevin C. Higgins **ENERGY STRATEGIES, LLC** 30 Market Street, Suite 200 3 Salt Lake City, Utah 84101 4 Michael L. Kurtz **BORHM KURTZ & LOWRY** 36 E. Seventh Street, Suite 2110 Cincinnati, Ohio 45202 David Berry P.O. Box 1064 Scottsdale, Arizona 85252 William P. Inman 9 Dept. of Revenue 1600 W. Monroe, Room 911 Phoenix, Arizona 85007 11 Robert Baltes ARIZONA COGENERATION ASSOC. 7250 N. 16th Street, Suite 102 Phoenix, Arizona 85020-5270 13 Jana Van Ness APS Mail Station 9905 P.O. box 53999 Phoenix, Arizona 85072-3999 16 **David Conture** TEP 17 4350 E. Irvington Road Tucson, Arizona 85714 18 Jana Brandt 19 SRP Mail Station PAB211 20 P.O. Box 52025 Phoenix, Arizona 85072-2025 21 Randall H. Warner 22 JONES SKELTON & HOCHULI PLC 2901 N. Central Avenue, Suite 800 23 Phoenix. Arizona 85012 John A. LaSota, Jr. MILLER LASOTA & PETERS, PLC 5225 N. Central Ave., Suite 235 Phoenix, Arizona 85012

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